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IN THE
Supreme Court of the United States

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION and
UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writs of Certiorari
to the United States Court of Appeals
for the Eighth Circuit

BRIEF FOR RESPONDENTS BELLSOUTH, SBC, VERIZON, AND USTA

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
STEVEN G. BRADBURY
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 15th Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Verizon Entities

MARK L. EVANS
Counsel of Record
MICHAEL K. KELLOGG
SEAN A. LEV
KELLOGG, HUBER, HANSEN,
TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corp., SBC Communications Inc., and United States Telecom Association

June 8, 2001

(Additional Counsel Listed on Inside Cover)

BEST AVAILABLE COPY

MICHAEL E. GLOVER
VERIZON
1320 North Courthouse Road
8th Floor
Arlington, Virginia 22201
(703) 974-2944

ANDREW G. MCBRIDE
SCOTT DELACOURT
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7135

HENRY WEISSMANN
MUNGER, TOLLES &
OLSON LLP
355 South Grand Avenue
Los Angeles, Calif. 90071
(213) 683-9100

Counsel for Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309
(404) 249-4839

Counsel for BellSouth Corporation

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
CHRISTOPHER M. HEIMANN
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States Telecom Association

CORPORATE DISCLOSURE STATEMENTS

Pursuant to Rule 29.6 of the Rules of this Court, respondents BellSouth Corporation, SBC Communications Inc., the Verizon Entities,* and the United States Telecom Association state the following:

BellSouth Corporation has no parent company, and no publicly owned company owns 10% or more of its stock.

SBC Communications Inc. has no parent company, and no publicly owned company owns 10% or more of its stock.

On June 30, 2000, GTE Corporation and Bell Atlantic Corporation closed their merger, and Bell Atlantic Corporation subsequently changed its name to Verizon Communications Inc. Verizon Communications Inc. is the ultimate parent of each of the other Verizon Entities. No publicly owned company owns 10% or more of the stock of Verizon Communications Inc.

The United States Telecom Association ("USTA") is a non-profit trade association. USTA has no parent companies, subsidiaries, or affiliates with respect to which disclosure is required by Rule 29.6.

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* The Verizon Entities consist of Verizon Communications Inc., GTE Service Corporation, GTE Alaska Incorporated, GTE Arkansas Incorporated, Verizon California Inc. (f/k/a GTE California Incorporated), Verizon Florida Inc. (f/k/a GTE Florida Incorporated), GTE Midwest Incorporated, Verizon South Inc. (f/k/a GTE North Incorporated), GTE Southwest Incorporated, Verizon North Inc. (f/k/a GTE North Incorporated), Verizon Northwest Inc. (f/k/a GTE Northwest Incorporated), Verizon Hawaii International Inc. (f/k/a GTE Hawaiian Telephone Company Incorporated), Verizon West Coast Inc. (f/k/a GTE West Coast Incorporated), Contel of Minnesota, Inc., and Contel of the South, Inc.

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STATEMENT

1. Before 1996, local telephone service was a monopoly provided at retail prices regulated by state public utility commissions. In adopting the Telecommunications Act of 1996, however, Congress concluded that facilities-based competition was both possible and desirable. Accordingly, the Act abolished exclusive franchises, 47 U.S.C. § 253(a), opened the local market to competition from new entrants, with whom incumbent local exchange carriers were required to interconnect, *id.* § 251(c)(2), and imposed a new federal obligation on incumbents to continue to provide retail and wholesale services, *id.* §§ 214(e), 251(c).

In order to promote facilities-based entry by firms that might not have complete networks at once, Congress required incumbents to make available discrete parts of their network, which rivals could combine with their own facilities to produce retail telephone service. *See* 47 U.S.C. § 251(c)(3). In addition, Congress required incumbents to sell their finished services at wholesale discounts for resale by new entrants. *See id.* § 251(c)(4). The resale provisions would allow competitors to enter markets quickly and establish brand recognition while expanding their facilities to match their marketing efforts.

Although the 1996 Act thus established the necessary conditions for local telephone competition to emerge, it did not purport to create a fully competitive industry overnight. Competition took years to develop in the long-distance market.[1] Nevertheless, the FCC apparently believed that,

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[1] It took more than two decades for AT&T to lose approximately 40% of its market share to new competitors. *See, e.g.*, Joel I. Klein, "The Race for Local Competition: A Long-Distance Run, Not a Sprint," *reprinted in Is the Telecommunications Act of 1996 Broken?* 57 (J. Gregory Sidak ed., 1999). Local competition has developed more quickly than long-distance competition. *See, e.g.*, William E. Kennard, Chairman, FCC, "A Competitive Call to Arms," Remarks Before the Association of Local Telecommunications Services (ALTS) Convention (May 3, 1999).

given Congress's judgment in the 1996 Act that there could and should be competition in local telephony, it risked being accused of poor stewardship if competition did not immediately emerge. If real competition could not develop overnight, the agency concluded, it would create the *appearance* of competition.

The FCC therefore undertook to cultivate not competition, but a proliferation of "competitors," even if their only contribution was the rebranding and marketing of services produced entirely through the incumbent's network. First, the FCC misinterpreted the "necessary and impair" standard of Section 251(d)(2) by deciding that new entrants should have access to any element of the incumbent's system that might marginally increase their ability to compete. The FCC thus read the statutory term "necessary" to mean "useful" or "apt" and the term "impair" to encompass any potential increase to a competitor's costs. *See Order* ¶¶ 277-288. This Court later rejected the FCC's blanket-unbundling approach as violating the plain text of Section 251(d)(2). *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 387-92 (1999). Yet, on remand, the FCC readopted the same blanket-sharing regime with only cosmetic changes.[2]

Second, and most critical here, the FCC interpreted the statutory pricing provisions for network elements to call for rates based on "forward-looking" costs. These costs were to be estimated pursuant to a new methodology called "TELRIC." *See Order* ¶¶ 672-740. Despite the statutory

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[2] *See Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 FCC Rcd 3696 (1999), *petitions for review pending, USTA v. FCC*, Nos. 00-1015, *et al.* (D.C. Cir.). The FCC bootstrapped itself to that result by concluding that entrants are "impaired" for purposes of Section 251(d)(2)(B) whenever they cannot obtain elements from sources other than the incumbent at TELRIC rates. *See id.* ¶ 341 n.673.

requirement that rates be "based on the cost . . . of providing the . . . network element," *see* 47 U.S.C. § 252(d)(1)(A)(i), the agency explicitly rejected any measure tied to the incumbent's actual network and present or future cost structure. By manipulating a purely hypothetical cost measure, the agency could give away network elements at fire-sale, below-cost prices, thereby propping up visible competitors through wealth transfers from incumbents.

Instead of a limited sharing mechanism to promote facilities-based entry, the FCC had created an irresistible opportunity for regulatory arbitrage. While the statute tied wholesale prices for finished services expressly to retail rates, and thus to incumbents' actual costs, *see* 47 U.S.C. § 252(d)(3), the FCC had now created an alternative resale mechanism at below-cost rates. Despite Congress's command to eliminate implicit cross-subsidies that cannot survive in a competitive market, *see id.* § 254, urban and business rates continue to be set at a premium in order to make up for below-cost rates for high-cost, rural, and residential customers. Through TELRIC prices, new entrants are able to use the incumbent's own facilities to undercut the incumbent's prices and "cream skim" subsidies intended to promote universal service. As this Court noted in *Iowa Utilities Board*, such a scheme leaves incumbents "holding the bag for universal service." 525 U.S. at 393. TELRIC also makes true facilities-based competition less attractive and thus skews competitive entry in favor of rebranding competition focused only on high-margin business customers.

2. The FCC's adoption of a forward-looking methodology represented something of a throw-back to times long past. In the early years of the past century, forward-looking methodologies were widely used in utility price regulation. *See* Charles F. Phillips, Jr., *The Regulation of Public Utilities* 319-22 (3d ed. 1993) ("Phillips, *Regulation of Public*

Utilities").[3] In later years, however, utility regulators almost uniformly rejected forward-looking approaches — especially blank-slate ones — in favor of historical-cost methodologies. More important, forward-looking methodologies had come under increasingly powerful attack. Two criticisms were most prevalent.

First, because replacement methodologies leave the solid ground of actual transactions — asking not what was actually paid (provable by reviewing ledgers and invoices) but rather what might be paid (provable only by expert testimony) — ratemaking degenerates into speculation. *See, e.g., Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 298 (1923) (Brandeis, J., concurring in the judgment). Regulators therefore concluded that "to determine the replacement cost of a plant or equipment is too complex a task for an administrative process." Stephen Breyer, *Regulation and Its Reform* 38 (1982).

Second, forward-looking methodologies can expose regulated firms to massive risk not present under historical-cost methodologies — namely, the risk that capital investment cannot be recovered where its value decreases due not to inefficient investment choices but to industry-wide cost trends.[4] Thus, it has long been recognized that, compared to a historical-cost methodology, a forward-looking cost

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[3] Even when their use was prevalent, forward-looking methodologies were generally only one component of establishing rates. *See, e.g., McCardle v. Indianapolis Water Co.*, 272 U.S. 400 (1926).

[4] A simple example shows why this is so. Assume a utility purchases a plant costing $100 and having an expected economic life of 10 years. Further assume that regulators use a forward-looking cost methodology, under which rates are redetermined on the basis of current costs once every year. Finally assume that, the next year, a new technology is unexpectedly invented so that a plant with the same output and expected economic life costs only $80. Without more, the utility will not recover its $100 investment: annual cost recovery immediately drops from, say, $10 to $8.

methodology requires the use of a substantially higher cost of capital.[5]

These well-established defects of a replacement-cost methodology are amplified to the point of absurdity in a context such as the valuation of a telecommunications network. Innovation is constant and often unforeseen. Ten years ago, no regulator would have predicted the commercial success of the Internet or that more than 100 million Americans would use wireless phones. Attempting to project and price possible technological advancements for elements that have a life of 30 years or more is inherently arbitrary. *See Iowa Utils. Bd.*, 525 U.S. at 425 (Breyer, J., concurring in part and dissenting in part) (noting difficulty of applying forward-looking measures in a dynamic industry like telecommunications).

According to the FCC, forward-looking cost methodologies attempt to approximate the long-run costs of producing a certain amount of incremental output, *see Order* ¶ 675, with the "long run" defined as a period so long that all facilities will be replaced over that period, *see id.* ¶ 677. In making that calculation, it is necessary first to quantify the size of the assumed output increment, because "costs . . . will vary greatly depending on the size of the increment." *Id.*

Apparently drawing on its blanket-unbundling approach (under which incumbents must share their entire network, *see id.* ¶¶ 283-285), the FCC determined that the relevant increment was the incumbents' entire output, *see id.* ¶ 690; 47 C.F.R. § 51.505(b). On that theory, the FCC's methodology asked what particular elements would cost if the entire telephone network were rebuilt from scratch, as though writing on a blank slate. *See Order* ¶¶ 683-685. The FCC

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[5] *See, e.g., Southwestern Bell*, 262 U.S. at 307-08 (Brandeis, J., concurring in the judgment); Irston R. Barnes, *The Economics of Public Utility Regulation* 413 (1942); D. Philip Locklin, *Economics of Transportation* 382 (7th ed. 1972); Phillips, *Regulation of Public Utilities* 336; James C. Bonbright, *Principles of Public Utility Rates* 186, 187 (1961).

then projected a hypothetical "least cost, "most efficient" network that at all times deployed solely the latest technology and that always maintained an optimal network design. The FCC's only concession to reality was to assume that this imaginary network would incorporate an incumbent's existing wire-center locations. *Id.* ¶ 685. By permitting recovery only of the costs it projected for this hypothetical network, *see* 47 C.F.R. § 51.505(b)(1), the FCC exposed incumbents to constant downward repricing of their existing networks.

As the FCC knew well, the overall costs of its TELRIC network would be far lower than the overall costs of any network that has been built, or could be built, in the real world, thereby ensuring that TELRIC rates for network elements would be artificially low. Technological advances have permitted substantial cost efficiencies in the local telephone industry.[6] Thus, existing networks necessarily cannot at all times meet the optimal-efficiency assumption of a blank-slate approach. Once a carrier has built its network, it is locked into its technology and configuration; it cannot start from scratch each time changed conditions would make a different network optimal for present conditions.

Five years of experience with TELRIC have borne out incumbents' worst fears. Network-element rates have been set at only *one-half* or even *one-third* of historical costs.[7] Rate-setting proceedings have degenerated into absurd fantasy. As one district court put it: "Because TELRIC focuses on a mythical network instead of [the incumbent's] existing network, each party [is] free to offer its own vision of this mythical network, limited only by the party's audacity and its ability to procure an expert witness willing to endorse that party's

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[6] *See, e.g., Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, ¶ 157 (1995).

[7] *See* No. 00-511 Verizon Br. 11 n.6; Brief for Respondents Southwestern Bell Telephone Co., *et al.*, at 31-32 & n.25, *GTE Serv. Corp. v. FCC*, No. 99-1244 (U.S. filed Aug. 14, 2000).

vision." *U.S. West Communications, Inc. v. Jennings*, 46 F. Supp. 2d 1004, 1009 (D. Ariz. 1999); *see also* Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation, or: Temptation of the Kleptocrats and the Political Economy of Regulatory Disingenuousness* 93 & n.135 (Inst. of Pub. Utils. & Network Indus., 1998) ("Kahn, *Letting Go*").

That sense of frustration is fully justified, for costs have been fantasized to outlandish lows. For example, some regulators have held that the hypothetical network must be assumed to consist entirely of new switches that are perfectly sized for current demand.[8] That is so even though switch manufacturers sell switches and add-on capacity as razors and blades: they sell the switch cheaply to lock in the customer, and then price add-on modules more expensively. But in perfectly engineered networks, the reasoning goes, no add-on modules would exist.[9] Similarly, other regulators have determined that loading coils on copper loops that are necessary for voice service but that impede digital subscriber

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[8] *See Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F. Supp. 2d 218, 237-39 (D. Del. 2000); Alfred E. Kahn, *Whom the Gods Would Destroy, or How Not to Deregulate* 55 n.7 (2001) ("Kahn, *How Not to Deregulate*").

[9] The distortion would be severe even without the razor-and-blades effect. The current generation of switches (digital switches like Lucent's 5ESS) is nearing the end of its 20-year run and is about to be replaced by other kinds of switches, including optical and packet switches. Pending that development, manufacturers sell new digital switches at deflated prices. *See, e.g.*, E.C. Buck, Donaldson, Lufkin & Jenrette Securities, Investext Rpt. No. 2748031, *Telecommunications Equipment: Outlook For 1999 - Industry Report* at *2 (Mar. 10, 1999). The FCC of course assumes that its hypothetical carrier buys switches at today's low prices, not at the high prices charged years ago, when incumbents actually bought their switches. *See Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 FCC Rcd 20156, ¶ 317 (1999).

line ("DSL") service should be removed for free.[10] In a perfectly engineered network, the reasoning goes, loading coils would never have been added to loops that were destined to be used for DSL service all along.

The adverse effect of the FCC's radically discounted TELRIC prices, aggravated by the FCC's blanket unbundling of UNEs, was predictable. Subsidized access to the incumbent's network provided a powerful distorting incentive for entrants to rely on UNEs and at the same time devalued investments that some entrants had started to make in facilities of their own. As a result, many entrants rapidly changed their plans away from deploying competing facilities. *See* No. 00-511 Verizon Br. 13 n.9.

3. The FCC still was not quite done with its bid to prop up visible competitors through its extra-statutory "resale" at below-cost unbundling rates. Although "platform" unbundling allowed entrants to commandeer any combination of network elements that already exists in the incumbent's network, an entrant might sometimes want access to combinations not yet in existence. Entrants could lease the requisite elements and combine them themselves, but that would require entrants to be something more than storefront marketing operations. The FCC therefore established a series of rules that not only prohibited incumbents from separating already-combined network elements (47 C.F.R. § 51.315(b)), but also required incumbents, "[u]pon request," to "combine unbundled network elements in any manner, even if those elements are not

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[10] *See Investigation by the Department on Its Own Motion as to the Propriety of the Rates and Charges Set Forth in M.D.T.E. No. 17, Filed with the Department by Verizon New England, Inc. d/b/a Verizon Massachusetts on May 5 and June 14, 2000, To Become Effective October 2, 2000*, D.T.E. 98-57-Phase III, Order at 103-07 (Mass. D.T.E. Sept. 29, 2000); *see also Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776, ¶ 250(1) (1997) ("*Universal Service Order*").

ordinarily combined in the incumbent's network" (*id.* § 51.315(c)).

The FCC sought to justify these obligations not on the basis of the "nondiscriminatory access" requirements of Section 251(c)(3), but rather on the same discredited basis on which it defended its original, expansive list of network elements — namely, that incumbents could be required to unbundle any network element that it was technically feasible to unbundle. *See Order* ¶ 295. That is precisely the theory that this Court later held to be "undoubtedly wrong." *Iowa Utils. Bd.*, 525 U.S. at 391.

4. Incumbents challenged the *Order* in the Eighth Circuit, contending that "the TELRIC method violates the plain language and purpose of the Act and represents arbitrary and capricious decision-making." Pet. App. 6a. The court agreed in part, holding that, although a forward-looking methodology was not inconsistent with the statute, a blank-slate approach, such as TELRIC, was contrary to the statute. The statutory words "based on the cost . . . of providing the interconnection or network element," the court explained, indicated that Congress did not mean to base network-element rates "on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished." *Id.* at 8a-9a.

That interpretation was consistent with the court's view that the statute permitted a forward-looking approach. As the court put it: "Costs can be forward-looking in that they can be calculated to reflect what it will cost the ILEC in the future to furnish to the competitor those portions or capacities of the ILEC's facilities and equipment that the competitor will use." *Id.* at 9a; *see also id.* at 13a-14a ("[A] forward-looking cost calculation methodology that is based on the incremental costs that an ILEC actually incurs or will incur in providing the interconnection to its network or the unbundled access to its specific network elements requested by a competitor will

produce rates that comply with the statutory requirement of § 252(d)(1) that an ILEC recover its 'cost' of providing the shared items.").[11]

The court of appeals had earlier set aside the additional-combinations requirement imposed in Rules 315(c)-(f). *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 813 (8th Cir. 1997). The court held that the rules were contrary to Section 251(c)(3), which, after providing in the first sentence that incumbents must make unbundled network elements available to requesting carriers, provides in the second sentence that incumbents must do so "in a manner that allows *requesting carriers* to combine such elements in order to provide such telecommunications service." 47 U.S.C. § 251(c)(3) (emphasis added). The court explained that the statute's plain terms reflected an expectation that the requesting carriers, not the incumbent, would be responsible for combining the requested elements. *See* 120 F.3d at 813.

In 1997, the FCC and its supporters failed to seek review of the Eighth Circuit's invalidation of the additional-combinations rules. Accordingly, this Court's previous opinion in this case did not address Rules 315(c)-(f). Nevertheless, petitioners argued on remand that, by ruling that the FCC could lawfully prohibit incumbents from separating *already-combined* elements (*Iowa Utils. Bd.*, 525 U.S. at 394-95), this Court had necessarily undermined the court of appeals' prior holding with respect to Rules 315(c)-(f).

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[11] The court of appeals also held that, in calculating wholesale prices under Section 252(d)(3), the statute allowed for deduction of only those retailing costs *that the incumbent actually avoided*, not costs that were theoretically avoidable or costs that would not be incurred by an optimally efficient wholesaler. *See* Pet. App. 19a-20a. Both WorldCom and AT&T challenged that ruling in their respective petitions for certiorari, but this Court declined to grant review of that question. *See* 121 S. Ct. 877, 878 (2000) (granting AT&T's and WorldCom's petitions but limiting consideration to three specifically delineated issues).

As the Eighth Circuit explained, however, that holding did not affect the legally distinct question of who should do the work necessary to improve the incumbent's network where elements were not already combined. *See* Pet. App. 28a. Whereas Congress had left ambiguous whether an incumbent may separate already-combined elements, the court said, Congress had "directly spoken on the issue of who shall combine previously uncombined network elements" — it provided that an incumbent carrier need do no more than provide elements "'in a manner that allows requesting carriers to combine such elements in order to provide such telecommunication service,'" leaving to the competing carrier the job of assembling the elements as it saw fit. *Id.* at 28a-29a (quoting 47 U.S.C. § 251(c)(3)).

SUMMARY OF ARGUMENT

1. The 1996 Act requires rates for network elements to be based on the costs that the incumbent will necessarily incur to provide those network elements to entrants. The "cost . . . of providing the . . . network element," 47 U.S.C. § 252(d)(1), refers to the *incumbent's* cost of providing elements of *its* network, not to a hypothetical entrant's cost of providing elements of another network. Related provisions of Section 252(d) confirm its focus on the incumbent's actual costs. As the Eighth Circuit succinctly stated: "Congress was dealing with reality, not fantasizing about what might be." Pet. App. 9a.

a. TELRIC violates the statutory standard by basing network-element rates not on the actual costs of the incumbent's existing network, but on the hypothetical costs of an imaginary carrier in a perfectly competitive market.

No incumbent could achieve the costs posited by a model that assumes a "blank slate" replacement of its network. TELRIC ignores the reality that the incumbent has an existing network whose future capital costs and operating expenses are in large part dictated by the network's current configuration.

An incumbent could not meet the TELRIC standard without actually tearing out its network and rebuilding it instantaneously from scratch, which it cannot and should not do. An incumbent's inability to achieve the cost structure posited by TELRIC reflects not "inefficiency," but rather the unattainability of TELRIC's hypothesis.

TELRIC cannot be said to reflect a current market value, nor does such a market exist. But even if TELRIC did reflect the "market value" of an incumbent's assets, the incumbent cannot be forced to provide its network at less than its cost.

b. Even if it were proper to base compensation for network elements on an imaginary competitive market, TELRIC bears no relation to prices that could actually prevail in this kind of market. In a capital-intensive competitive industry marked by technological change, firms replace their assets gradually, not all at once every time a new technology is introduced. Prices in such markets reflect the need to recover capital investments. Firms require extraordinarily high rates of return and depreciation to compensate for the risk that their investments will be unrecoverable. The FCC's failure to adopt a rate of return and depreciation schedule that reflect what would occur in such a competitive market is the epitome of arbitrary decisionmaking. For purposes of determining capital investment, the FCC posits a perfectly competitive market with continual blank-slate replacement of the assets; but for purposes of determining the rate of return and depreciation, the FCC started with the rates established in the old monopoly environment and prohibited any changes unless incumbents could show that *actual* facilities-based competition for network elements had emerged. The FCC thus jumps back and forth between the hypothetical world of perfect competition and the real world of actual competition, producing a methodology whose only consistency is to adopt whatever assumption produces the lowest compensation for the incumbents.

c. Constitutional considerations reinforce a construction of the Act that requires compensation to be based on costs the incumbent will necessarily incur. A government program that *forces* a particular firm to provide a service on an ongoing basis, but that fails to cover the costs that the firm will necessarily incur to comply with that directive, raises serious problems under the Takings Clause. The Act should be construed to avoid these problems.

2. Having declined to challenge the Eighth Circuit's invalidation of Rules 315(c)-(f) (the additional-combinations rules) when they last sought review in this Court, petitioners abandoned their claim, and this Court should not consider it on the merits. Nothing in this Court's prior decision or in the Eighth Circuit's remand decision resuscitates petitioners' claim.

In any event, the additional-combinations rules are incompatible with the statute, which envisions that "requesting carriers," not incumbents, will "combine such elements" to suit their own needs. 47 U.S.C. § 251(c)(3). Congress did not require incumbents to put their employees at the disposal of their competitors to do work that the competitors themselves can and should do themselves. The additional-combinations rules are not at all like Rule 315(b), upheld in *Iowa Utilities Board*, which prohibits incumbents from "sabotag[ing]" their networks by separating already-combined network elements solely "to impose wasteful reconnection costs." 525 U.S. at 394-95 (internal quotations omitted). That analysis has no relevance here, where incumbents are not "sabotaging" anything, but rather placing entrants in the same position as incumbents. Moreover, whereas Rule 315(b) was grounded in the statute's nondiscrimination requirement, the FCC predicated Rules 315(c)-(f) on the same "technical feasibility" theory that this Court called "undoubtedly wrong" (*id.* at 391) when it struck down the agency's unbundling rule. Because the additional-combinations rules have no foundation

in the statute, the Eighth Circuit's decision invalidating them should be affirmed.

ARGUMENT

I. THE FCC ACTED UNLAWFULLY IN ADOPTING ITS TELRIC METHODOLOGY.

Assuming for purposes of this brief that the 1996 Act does not require that network-element rates be set to allow recovery of an incumbent's historical costs, but rather permits the FCC to use a forward-looking cost methodology (*but see* No. 00-511 Verizon Br.), the FCC nevertheless acted unlawfully in adopting TELRIC.

A. TELRIC Improperly Disallows Recovery of Costs That Incumbents Will Necessarily Incur in Providing Network Elements.

The Act compels incumbents to turn over parts of their existing network to competitors. This requires the incumbents to incur, for the benefit of competitors, the full forward-looking costs of furnishing and operating those particular facilities. TELRIC is unlawful because it disallows recovery of these necessarily incurred costs and instead limits incumbents to recovery based on a hypothetical standard of optimal efficiency that does not exist today and that no incumbent could possibly achieve in the future. This imaginary blank-slate approach conflicts with the language and purpose of the Act, and is arbitrary and capricious.

1. The Eighth Circuit correctly held that the Act requires network-element rates that cover the actual costs that incumbents will necessarily incur in providing those elements to entrants. Section 252(d)(1)(A)(i) mandates that unbundled-network-element rates be "based on the cost . . . of providing the . . . network element." The statute thus focuses on the specific physical facilities that are already in place (the existing telephone network currently operating to provide retail service), and the costs "of providing" those facilities

necessarily means the costs incumbents must incur in furnishing and operating those real-world assets. The Eighth Circuit was therefore correct in concluding that the relevant costs are the incumbents' actual costs, not "the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished." Pet. App. 8a-9a.[12]

The related pricing standards in Section 252(d) confirm this reading. Section 252(d)(3) provides that the wholesale rate for finished services purchased for resale must equal "retail rates . . . , excluding the portion thereof attributable to . . . costs that will be avoided *by the local exchange carrier.*" 47 U.S.C. § 252(d)(3) (emphasis added). The Eighth Circuit properly concluded that this resale standard refers to the retail costs that the incumbent can actually avoid, not the costs that could be avoided by a hypothetical carrier that does not engage in retailing. *See* Pet. App. 19a-20a. To maintain harmony among the related provisions of Section 252(d), *see Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995), the pricing standard for network elements must likewise be construed to refer to the costs of the incumbent, not those of a hypothetical entrant.

Similarly, Section 252(d)(2)(A)(i) provides that "reciprocal compensation" rates must "provide for the . . . recovery by each carrier of costs associated with the transport and termination *on each carrier's network facilities.*" 47 U.S.C. § 252(d)(2)(A)(i) (emphasis added). Because both of these adjacent pricing provisions in Section 252(d) require rates to

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[12] The statute further provides that lease rates must be "just and reasonable," 47 U.S.C. § 252(d)(1), and "may include a reasonable profit," *id.* § 252(d)(1)(B). A network-element rate can be neither "just" nor "reasonable" if it systematically denies recovery of the incumbent's actual costs. And a rate could not be viewed as allowing an incumbent a "reasonable profit" unless it first permits the carrier to recover its own costs.

be set by reference to the costs of incumbents, not the costs of some imaginary carrier, the standard for pricing network elements in Section 252(d)(1) must be taken to refer to the same standard.[13]

The Act's focus on the costs *to the incumbent* of providing *its* network is only logical. Say, for example, that Congress *ordered* Newport News Shipbuilding immediately to construct a supercarrier and promised to pay the shipyard's "cost of providing the carrier." The Defense Department could not refuse to pay the costs Newport necessarily incurred in building the ship and instead pay what it hypothesizes would be Newport's costs if its whole shipyard were rebuilt from scratch and operating in a perfectly competitive supercarrier market.

Because the statute requires recovery of actual costs, any methodology must be directed at ascertaining the costs that incumbents will *actually incur* to comply with the government's mandate.

2. TELRIC violates this standard because it fails to cover costs incumbents will necessarily incur and limits recovery to a hypothetical standard of efficiency that incumbents cannot achieve. Specifically, the FCC posits three assumptions: (1) that the market for network elements is in a state of perfect competition today; (2) that there is, *at any given time*, a new entrant that has deployed a complete network using the perfectly efficient technology and design *for that instant*; and (3) that each successive blank-slate new entrant, and all competitors that preceded it, would instantaneously drop prices to the cost of this imaginary perfect network.

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[13] The legislative history likewise confirms the statutory focus on the costs of the incumbent. The House bill called for pricing standards "requir[ing] that *the costs that a carrier incurs* in offering . . . unbundled . . . elements . . . shall be borne by the users of such . . . elements." H.R. Rep. No. 104-204, Pt. 1, at 4 (1995) (emphasis added).

a. Plainly, no incumbent could furnish network elements at this make-believe cost. Unless incumbents scrap their existing networks, incumbents' forward-looking operating and capital costs are necessarily determined by the configuration of the network already in place. For incumbents, both achievable operating costs and the range of choices for most efficient new investments in the network are determined by the network already in place.

This concept of "path dependency" is familiar to any purchaser of a PC, who cannot later take advantage of the most efficient release of Apple software, but is limited to the range of PC-compatible software. So, too, in the telecommunications industry, an incumbent that has purchased switches from, say, Lucent will often find it more efficient to purchase add-ons from that vendor than to rip out the switch and purchase a new one from Nortel, even if the Nortel switch would then be cheaper than the Lucent switch. Similarly, once the incumbent has installed a line of telephone poles along one route to serve an existing set of customers, it will likely be cheaper for the incumbent to serve new demand by building out from the existing route of poles, even though, if it were designing the whole network today, it could select a more efficient route.

Nor can an incumbent instantaneously attain TELRIC costs by tearing down its existing network and building a new one from scratch. Apart from the practical reason that an incumbent could not instantaneously displace the existing network used to meet its service obligations *today*, no rational incumbent would follow such a suicidal business plan even if it were theoretically possible. As explained more fully below, blank-slate replacement is manifestly inefficient *in the long run* in this kind of industry. The local telephone business is marked by huge capital investments, long-lived capital assets, and rapid technological change. In this kind of market, no carrier could start from scratch each time changed conditions

or new technology would make a different network optimal under conditions then prevailing. If it did, it could never recover its investments. That is why firms in such industries replace their facilities in phases. Phased replacement allows a firm to maximize its cost recovery, positions it best to respond efficiently to changing conditions, and reduces technological risks.

The FCC and its supporters strongly imply (though without pointing to any proof) that, if incumbents are unable to live up to the TELRIC ideal, this is simply because they are or have been guilty of making imprudent investment choices. *See, e.g.*, FCC Br. 21; WorldCom Br. 13, 28-29, 32, 39; Sprint Br. 17; AT&T Br. 17, 33, 38. The implication that central government planners could somehow design telephone networks more efficiently than private-sector management is of course facially implausible. That is particularly so because incumbents have now been subject to more than a decade of price-cap regulation, the purpose of which is to mimic investment incentives that prevail in competitive markets, *see* AT&T Br. 6, and the bulk of incumbents' investment was installed during that period, *see* Reply Affidavit of William Baumol, Janusz Ordover & Robert Willig ¶¶ 8, 15, submitted with AT&T Reply Comments, CC Docket No. 96-98 (FCC filed May 30, 1996) ("Baumol Reply Aff.") (JA 144, 147).

The much more likely explanation is that the FCC has simply overlooked the fundamental fact that, in an industry with long-lived capital investment, a carrier is constrained by its existing network. Even if all of a carrier's investment choices are optimally efficient at the time they are made, they will necessarily add up to a network that is not optimally configured for conditions prevailing at any given time. Thus, even a carrier that at all times acts with optimal efficiency would not and could not meet the TELRIC ideal.

b. Shifting ground, the FCC and its supporters next claim that, even if the incumbent itself might not be able to achieve

TELRIC costs, there would be at any time in a competitive market *other* firms (entrants) that *could* start from scratch and thereby meet the TELRIC ideal. And because the market price of network elements would at all times equal the costs of the most efficient entrant, the theory continues, the incumbents would have to meet the entrants' price. *See* FCC Br. 29; *see also* WorldCom Br. 9, 31-32, 38; Sprint Br. 20; AT&T Br. 30. Thus, the theory concludes, the incumbents' network elements should be valued *today* at the value that the theory hypothesizes would eventually prevail in a competitive market. FCC Br. 29; *see also* Sprint Br. 20; AT&T Br. 30.

This effort immediately to devalue incumbents' assets to their supposed "economic cost" (or value) based on their imaginary "fair market value" in a world of perfect competition fails for two obvious reasons. First, even if this perfect competitive state existed today, and there was *in fact* an alternative supplier with lower costs, neither the statute nor the Constitution would permit the government to force the incumbent to provide *its* network for less than *its* costs.

Second, there is *in fact* no alternative in an existing market *today*, and thus the FCC's "fair market value" is entirely an imaginary construct. It is no answer to say that this is nothing more than an "appraiser" looking at "market comparables." FCC Br. 28 n.12. The reason the Act requires the incumbent to provide network elements is presumably because there is no "market" and there are no "comparables."[14] Thus, the FCC's

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[14] There are no "comparable sales" in this context because the local telephone network is a unique property for which there has never been a working market. *See West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662, 672 (1935). Moreover, the TELRIC network is not a "comparable sale"; it is a hypothetical network whose only design constraints are the limits of a regulator's imagination. In terms of the real-estate analogy, with TELRIC, the "appraiser" simply posits the existence of a radical buyers' market, with newer, better-constructed, and cheaper houses springing up on a daily basis around the unfortunate homeowner whose residence is being appraised.

argument cannot be that TELRIC truly represents the incumbent's economic costs, or value, *today*. Rather, the FCC's premise is that the incumbent's assets should be *treated as if* this was their value based on an imaginary state of affairs. But the government cannot avoid compensation for the incumbent's costs on the basis of "market value" where no such market currently exists.

3. The FCC and its supporters suggest that it is somehow illogical to allow recovery of actual forward-looking costs — that is, to determine the costs that an incumbent will actually incur in furnishing network elements. Once one embraces a forward-looking approach, they suggest, one must *necessarily* assume a network rebuilt from scratch. *See, e.g.*, WorldCom Br. 29-30; Sprint Br. 15. But the FCC is wrong. A blank-slate method is not proper here because it does not project the costs really expected to be incurred in the long run.

The whole point of a forward-looking methodology is to ascertain how much will be spent, in reality, to produce goods or services in the long run. Indeed, the reason for using a forward-looking methodology is to determine how much of society's resources will be consumed in satisfying particular demand, so that consumers pay the real costs of what they use.[15] In this context — determining what a specific producer (namely, an incumbent in this market) will incur going forward — it makes no sense whatsoever to assume blank-slate replacement of the entire network.[16]

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[15] *See, e.g.*, Kahn, *How Not to Deregulate* 4 ("The entire logic of the marginal cost pricing principle requires that prices reflect the additional costs that society will actually incur or save if purchasers take somewhat more or somewhat less of the product or service in question.").

[16] As Professor Kahn explained a decade ago (long before the current controversy): "The concept of long-run incremental cost . . . takes a firm's past history as given, does not assume that it is writing on a blank slate, but recognizes that it will ordinarily be planning the installation of new capacity, at whatever that additional investment will cost given its

Why would it make no sense for an incumbent to scrap its network immediately? An incumbent must decide how best to invest in its overall network with a view toward being the most efficient provider of *all* services over the long run. This requires the incumbent to consider the real-world attributes of the market it actually confronts — one in which facilities-based competition is growing, capital investments are large and immobile, and the rate of technological change is high. In such a market, an incumbent that sought to meet each technological advance through sweeping network replacement would quickly go bankrupt. Rather, the rational incumbent will plan on phased replacement of its existing plant to enable it to recover its investments and to maximize its flexibility to respond to changing market and technological conditions.

An incumbent would have to be mad to sacrifice these efficiencies by replacing its entire network with the technology that would best suit the entrant that may remain a wholesale customer for only a short period. Entrants are allowed to use the incumbent's facilities at will without a long-term commitment, and a major purpose of the regime of forced leasing of network elements is as a transitional measure to facilities-based bypass by entrants. *See* FCC Br. 3; *see also* WorldCom Br. 5, 40-41. In this context, to make a long-term investment decision to suit the transitory needs of short-term customers makes no sense. Perhaps this might be different if there were an up-front guarantee that the incumbent would have a customer for the entire long-term output of a new investment. In that case, it might be rational for the incumbent to consider constructing entirely new facilities optimized to meet that firm demand. Here, of course, there is no

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current situation." Affidavit of Alfred E. Kahn at 22 n.26, submitted with Comments of Bell Atlantic, *Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141 (FCC filed Aug. 6, 1991).

guarantee that the entrants will remain wholesale customers of the incumbents over the long term.[17]

In the context of this capital-intensive industry, in which incumbents made investments subject to prudency review and incentive regulation, the logical starting point is the incumbent's current network configuration, assuming phased replacement of facilities over time in the real market. Indeed, the FCC implicitly acknowledges this in the portion of its *Order* explaining its approach to the location of wire centers. There, the FCC said that an approach "compatible with the existing infrastructure" — *i.e.*, one that reflects where central offices are actually located in the real world — "most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants." *Order* ¶ 685. The import of the FCC's reasoning is that, the less blank slate the model, the more accurate it is. Remarkably, the FCC refused to consider what would be "compatible" with the incumbents' actual networks in other respects, precisely on the grounds that such adjustments would enable incumbents to "recover costs based on their existing operations." *Id.* ¶ 684.

4. The FCC now claims that its wire-center exception cures TELRIC's fundamental flaws. *See* FCC Br. 23-24 n.8; *see also* Sprint Br. 18-19; AT&T Br. 33-34. But the wire-center exception cannot justify TELRIC — to the contrary, it underscores the irrational nature of the FCC's assumptions

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[17] A simple example makes the point. If Newport News produces 10 ships per year of different kinds for different purchasers, and is competing against other shipyards, it would not tear down its plant and rebuild it to optimize production of one supercarrier ordered by the government. Rather, it would orient itself toward being the most efficient shipyard over the long term for all the ships that it expects to build. It might be different if two conditions were met: (1) the government guaranteed overall demand by committing to 25 supercarriers over the next 25 years, and (2) the government committed to paying a fixed price, not subject to continual downward adjustment based on general market efficiencies.

with respect to aspects of the network other than the wire-center location.

The FCC's rationale for making the wire-center adjustment was precisely that it would bring its methodology more into line with the incumbent's actual forward-looking costs. *Order* ¶ 685. As the agency said in a brief that it filed in the Fifth Circuit, "although carriers may be able to replace technologies with the most efficient available, it would be far more difficult for them to modify certain key features of their network structures, such as the location of their wire centers." Brief for Respondent at 69, *Texas Office of Pub. Util. Counsel v. FCC*, No. 97-60421 (5th Cir. filed May 18, 1998).

It is certainly true that it would be extremely expensive and wasteful for incumbents "to modify . . . the location of their wire centers" whenever today's conditions make a different location more efficient. But modifying other aspects of the network would be just as expensive and wasteful. Reconfiguring distribution plant would involve uprooting and moving countless telephone poles to take advantage of cost savings that pale in comparison to the costs that must be incurred to reap them. Yet the FCC has nowhere explained why it is sensible to assume that an efficient carrier would undertake reconfigurations at least as impractical and wasteful as relocating a wire center.

The FCC also claims that the wire-center exception "provide[s] an incentive for new entrants to construct their own facilities." FCC Br. 24 n.8. That, too, is correct: the wire-center exception "encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost." *Order* ¶ 685. But what is not explained is why this kind of encouragement should be limited to the location of the wire center and should not equally extend to the rest of the telephone network. The *Order* does not and cannot provide answers to these obvious questions.

5. Ultimately, the FCC's reason for disallowing the incumbents' recovery of their actual costs boils down to the claim that TELRIC better promotes competition. Of course, the FCC's policy preference cannot justify ignoring the Act's directive to compensate the incumbents for their actual costs. But, in fact, the FCC's policy claim is not well-founded. TELRIC actually thwarts the process of competition and thus is at war with the fundamental purpose of the Act.

TELRIC has nothing to do with promoting competitive entry; it is all about *restricting* competitive entry. Using the incumbent's actual costs opens the door to competition by all entrants that believe they can beat the costs of the incumbent and any other future entrant. This will undoubtedly be a messy process, with plenty of mistakes and business failures. But the benefits of real efficiency and innovation can be achieved only through this competitive process. *See Iowa Utils. Bd.*, 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part) ("[t]he competition that the Act seeks is a process, not an end result").

The FCC was not content to open the market to competition and to initiate the process that would produce winners and losers. Thinking that process would involve "unnecessary" "duplication," *Order* ¶ 287, the FCC sought, in Professor Kahn's words, to "short circuit" the competitive process by intervening as a central planner to impose by regulatory *diktat* its view of the efficient outcome in advance.[18] But by attempting to leap-frog to the costs that it imagines would be attained by an ideally efficient carrier and by setting prices at that fanciful ideal, the FCC's approach will necessarily cut off

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[18] As Professor Kahn has explained, "[t]he Commission has in effect declared: '*We* will determine not what your costs are or will be but what we think they *ought to be*. Why should we bother to let the messy and uncertain competitive process determine the outcome when *we* can determine at the very outset what those results would be and prescribe them now?'" Kahn, *Letting Go* 92.

the true competition that Congress intended to foster. Even the FCC, in classic understatement, conceded that a hypothetical-network approach to pricing "may discourage facilities-based competition by new entrants because new entrants can use the incumbent's existing network based on the cost of a hypothetical least-cost, most efficient network." *Id.* ¶ 683. Indeed it will: any rational entrant would be far less likely to take the risk of investing in its own facilities when it can obtain their benefit at unbeatable prices.

B. The FCC Does Not Approximate the Costs of Entrants in Competitive Markets.

Even if it were proper to base compensation on an imaginary competitive market, the TELRIC model is fatally flawed: it defies economic logic, is rife with internal inconsistencies, and bears no rational relationship to the costs and prices that would prevail in such a market.

1. As discussed above, TELRIC's hypothetical world rests on the premise that, in a perfectly competitive telecommunications market, there will be at any given time a new entrant that has just deployed a blank-slate optimal network and that will immediately drop its prices to the costs of the newly deployed network.[19]

This model reflects a patently mistaken view of how markets work. In industries requiring huge sunk capital investments and involving rapid technological change, competitive markets do not function as the FCC posits.

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[19] Unlike its supporters, the FCC coyly states that the market price would merely "var[y] with the cost" of a new entrant. FCC Br. 23, 29. In addition, it suggests that TELRIC merely "consider[s]" and "takes into account" the costs of an optimally efficient network. *Id.* at 21, 28 n.12. In fact, TELRIC assumes that the market price would immediately *equal* the costs of an optimally efficient entrant, and it therefore *equates* rates with the (misapprehended) cost level of an optimally efficient carrier. *See* 47 C.F.R. § 51.505(b)(1); FCC Br. 6-7. Thus, a "var[y] with the cost" theory, even if correct, could not salvage TELRIC.

In even the most competitive industries, firms do not constantly deploy the latest and most efficient technology throughout their enterprise. *Accord* WorldCom Br. 38. For example, airlines, even on routes where effective competition exists (say, New York to London), often fly aircraft that are decades old. Air carriers do not necessarily replace their entire fleet of aircraft immediately each time Boeing introduces a less expensive, more fuel-efficient aircraft. Rather, at any given time, they have a mix of assets: some assets will be optimally efficient, and some will be less efficient but not yet so inefficient as to justify immediate replacement.

This is true for two reasons. First, capital investments, by definition, last longer than the blink of an eye. But, assuming technological progress, the most efficient airplane today will no longer be the most efficient airplane tomorrow. Thus, if a carrier set itself the goal of fully and constantly incorporating the most efficient technology available at any given time, it would find itself constantly replacing its entire fleet. If it did so, the carrier would be unable to recover the cost of its sunk investment: the facilities would not be earning revenue long enough to recoup the part of the investment that is sunk. Before too long, therefore, a carrier aiming for optimal efficiency at any given instant would go bankrupt. *See* Kahn, *Letting Go* 91.

Second, as a firm makes large capital investments in a network, it experiences "path dependency": those investments necessarily constrain subsequent choices about further investment. An airline that has committed itself to Boeing aircraft and has trained its pilots and maintenance crews accordingly will not replace its fleet simply because Airbus comes onto the market with a more efficient aircraft. Moreover, because of path dependency, even the most efficient real-world carrier would not consistently have an optimally configured network: locating a major hub in St. Louis might appear optimal today but would not be tomorrow. In short, once capital-intensive

networks are installed, "the most efficient or lowest marginal cost growth path . . . will be constrained by the totality of . . . existing facilities; that will be true of each investment . . . henceforward in either additions to or replacements of existing facilities or equipment." Kahn, *How Not to Deregulate* 4.

Thus, firms in competitive capital-intensive industries do not continuously scrap their entire networks as soon as a more efficient new technology comes along, nor do they instantaneously price their existing assets down to the level of the most efficient available technology. Instead, they practice so-called "anticipatory retardation": they replace assets piecemeal as they age, and prices drop gradually, not instantaneously, as all competitors seek to maximize recovery of their investments.[20] It is the cost of phased replacement of and addition to the resulting mix — not the cost of starting over from scratch — that determines the price level of the industry's output.

These basic facts apply with special force in the telephone industry. Telephone networks consist almost entirely of long-lasting and immobile capital assets, many subject to rapid technological change. Thus, competing firms (including new entrants) will share the same basic characteristics: their networks will have a mix of old and new technologies; their investment choices will be constrained by path dependency; and they all will practice anticipatory retardation to maximize their cost recovery.

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[20] In economic terms, firms speed up replacement only insofar as forward-looking costs decline sufficiently in relation to the market price to leave a margin allowing cost recovery over the predicted useful life of their investment. *See* Alfred E. Kahn, I *The Economics of Regulation: Principles and Institutions* 119-20 n.91 (1970) ("Kahn, *Economics of Regulation*") (citing William Fellner, *The Influence of Market Structure on Technological Progress*, in Am. Econ. Ass'n, *Readings in Industrial Organization and Public Policy* 277, 287-91 (Homewood: Richard D. Irwin, 1958)).

In sum, the FCC's depiction of full competition in the local telephone industry fails to take into account the inherent characteristics of that market. It was arbitrary and irrational for the FCC to treat the local telephone market as though it were the market for pork bellies. *See West*, 295 U.S. at 672 (noting that a telephone network "is a great integrated aggregate of many and diverse elements; is not primarily intended for sale in the market . . . ; and has, so far as its market value is concerned, no real resemblance to a bushel of wheat or a ton of iron").[21]

The TELRIC model is flawed in another fundamental respect: No rational new entrant would enter on the terms posited by the FCC. This is obvious for two reasons. First, even if the entrant could enter overnight with a network consisting of optimally efficient facilities, it would not price at the bare cost of its new network. The new entrant would be aware that its cost advantage would be transitory — the next year's new entrant would have a lower-cost network, the following year's entrant an even lower-cost network, and so forth. Second, the entrant would be subject to precisely the same economic realities as the incumbent market participants: once it builds its network, it is locked in.[22] Indeed, once it has built the network, the entrant is even more constrained than the incumbents. While incumbents can take advantage of newly developing technologies by practicing anticipatory retardation, the entrant is fully committed to today's tech-

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[21] *See also Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42-43 (1983) (agency must base action on relevant data and factors); *Columbia Falls Aluminum Co. v. EPA*, 139 F.3d 914, 923 (D.C. Cir. 1998) (agency use of a model is arbitrary if model "bears no rational relationship to the reality it purports to represent").

[22] Although the entrant would have the one-time ability to "write on a blank slate[,] . . . once it has done so, it too will never again be in a position to do so again on the basis of the latest technology." Kahn, *How Not to Deregulate* 55 n.8 (internal quotation marks omitted).

nology and configuration; it cannot gradually take advantage of better technologies that may come along later.

Therefore, the entrant would clearly understand that if it priced as the FCC supposed — at the level of the most efficient network — it would never recover its original investment and would go bankrupt in short order. A rational potential entrant would never enter the market. It would enter only it were able to earn an especially high rate of return — by charging prices well above TELRIC — during the short time that it enjoyed a technological advantage. Only in that way could it assure cost recovery in the face of continued entry and technological progress. In other words, a potential entrant into a hypercompetitive market would demand a commensurate rate of return.

Market prices therefore will *not* immediately drop to the construction costs of the latest entrant building a network optimally configured for today's conditions. If things were otherwise, all firms, including each successive entrant, would be unable to recover their costs, and every competitive market would constantly see waves of bankruptcies, as each entrant followed in the footsteps of the one before, like lemmings throwing themselves off a cliff.

In sum, in competitive markets where there is long-lived capital investment and technological progress, output prices do not constantly decline to the long-run costs of an optimally efficient entrant — at least not unless one counts as one of the components of that entrant's costs an appropriately increased cost of capital.[23]

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[23] The economic literature is in agreement with these elementary principles. *See supra* at 27 n.20; *see also* Kahn, *Letting Go* 91; Richard Schmalensee & William E. Taylor, *Economic Aspects of Access Reform: A Reply* at 6, Attach. 3 to USTA Reply Comments, CC Docket No. 96-262 (FCC filed Feb. 14, 1997); J. Gregory Sidak & Daniel Spulber, *Givings, Takings, and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L. Rev. 1068, 1141-43 (1997); Kahn, *Economics of Regulation*

2. The FCC's treatment of rates of return and depreciation in TELRIC is a textbook example of arbitrary and capricious decisionmaking.

The FCC's methodology purported to duplicate the prices a new entrant would charge in a perfectly competitive market. Incumbents presented evidence demonstrating that, for the reasons discussed above, a carrier's cost of capital in the market TELRIC hypothesized would have to be at least two to three times higher than the rate of return authorized in the old monopoly environment. *See* Reply Affidavit of Professor Jerry A. Hausman ¶ 9 n.8, submitted with Reply Comments of the United States Telephone Ass'n, CC Docket No. 96-98 (FCC filed May 30, 1996) (JA 197). The FCC glibly rejected this evidence simply on the basis that it was "not persuaded" that higher risks existed. *See Order* ¶ 688; *see also id.* ¶ 703. Instead, the FCC concluded that today's regulated rates of return were "a reasonable starting point." *Id.* ¶ 702; *see also Universal Service Order* ¶ 250(4). The FCC had the same to say about depreciation. *Order* ¶ 702; *see also Universal Service Order* ¶ 250(5).

But it was a complete *non sequitur* to assert that current rates of return and depreciation were proper because incumbents did not yet face significant facilities-based compe-

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119-20 n.91; Declaration of Alfred Kahn & Timothy Tardiff ¶ 8a, submitted with Bell Atlantic Reply Comments, CC Docket No. 96-98 (FCC filed May 30, 1996) (JA 154-55).

Indeed, in a 1998 article, even William Baumol (AT&T's expert), whose testimony before the FCC laid the theoretical foundation for the TELRIC methodology, publicly acknowledged the validity of these principles. *See* William Baumol & Thomas Merrill, *Does the Constitution Require That We Kill the Competitive Goose? Pricing Local Phone Services to Rivals*, 73 N.Y.U. L. Rev. 1122, 1147 (1998); *see also The New Investment Theory of Real Options and its Implications for Telecommunications Economics* 249 (James Alleman & Eli Noam eds., 1999). In his FCC testimony, by contrast, Professor Baumol ignored these principles. *See* Baumol Reply Aff. ¶ 3 (JA 141).

tition in the real world. The task that the FCC defined for itself was determining the costs that firms would theoretically face in a perfectly competitive market, even though they do not actually operate in such a market today. The FCC used its assumptions about what that market would look like to assume radically reduced costs for capital assets. To be consistent, the pricing methodology must determine the cost of capital and depreciation expenses by assuming the *same* hypothetical market — not by abruptly shifting ground and looking to the actual market conditions currently in existence.

By making that shift, the FCC was arbitrarily whipsawing incumbents between two worlds. On the one hand, the FCC geared its projection of the infrastructure costs of the network (the amounts expended on capital assets) to a world where there is always an instantaneous replacement of facilities with the latest and best, thereby *reducing* costs. On the other hand, the FCC ignored the astronomical rates of return and depreciation expenses that would prevail in such a world and instead set cost of capital and depreciation by looking at the actual amount of facilities-based competition that incumbents face. The agency "cannot have it both ways." *General Chem. Corp. v. United States*, 817 F.2d 844, 854 (D.C. Cir. 1987). It must apply assumptions consistently, and its refusal to do so is the epitome of arbitrary agency action. *See, e.g., id.*; *Iowa Terminal R.R. v. ICC*, 853 F.2d 965, 972 (D.C. Cir. 1988).

The FCC argues that any concerns about its approach to the rate of return and depreciation should be dismissed because the agency has actually left it up to state commissions to set those aspects of TELRIC costs. *See* FCC Br. 8 (asserting that the "FCC has given the state commissions great discretion to determine the appropriate cost of capital"). But that is false. Rather, the FCC dictated that state commissions must use as a "starting point" the "currently authorized rate of return at the federal or state level." *Order* ¶ 702. Further, it prohibited any departure from that existing rate of return

unless incumbents meet "the burden of demonstrating with specificity that the business risks that they face" justify a different cost of capital. *Id.* The FCC made clear, moreover, that the only "business risk" that would allow the States to adjust the rate of return was the actual emergence of competition for the provision of network elements. The FCC prohibited any rate of return adjustment until *after* such actual competition had in fact materialized. *See id.*; *see also id.* ¶ 687; FCC Br. 8. Similarly, for depreciation, though the agency paid lip service to the proposition that "properly designed depreciation schedules should account for expected declines in the value of capital goods," *Order* ¶ 686, it again ordered the use of "the currently authorized . . . depreciation rate," *id.* ¶ 702.[24]

Those instructions are not a *solution*; rather, they are the *problem*. It was entirely irrational both to use current rates as the starting point and to allow adjustments based only on actual market developments. Once TELRIC has been applied, the pace and extent of actual competitive developments in the market are immaterial. Whatever the status of competition in the real world, the FCC's use of TELRIC has exposed

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[24] Consistent with these marching orders, States have in fact employed existing utility rates of return and depreciation. *See, e.g., Opinion and Order Setting Rates for First Group of Network Elements*, Opinion No. 97-2, Case 95-C-0657, 1997 N.Y. PUC LEXIS 289, at *50-*81 (N.Y. Pub. Serv. Comm'n Apr. 1, 1997); *1998 Biennial Regulatory Review — Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, Report and Order in CC Docket No. 98-137, Memorandum Opinion and Order in ASD 98-91, 15 FCC Rcd 242, ¶ 69 (1999) (noting that 24 state commissions use FCC-prescribed depreciation factors in calculating UNE rates). Where they have not, the FCC has taken them to task. *See Application of Verizon New England Inc., et al., For Authorization to Provide In-Region, InterLATA Services in Massachusetts*, Memorandum Opinion and Order, CC Docket No. 01-9, FCC 01-130, 2001 WL 388287, ¶ 38 (rel. Apr. 16, 2001) (criticizing State for selecting a cost of capital "higher than the cost of capital . . . used in setting . . . local rates").

incumbents today to constant downward repricing just as if TELRIC's hypercompetitive state already existed. Any rate of return used in projecting costs must reflect that risk.[25]

Further, it was particularly irrational for the FCC to permit adjustments to rates of return and depreciation only after competition has already developed. The idea that regulators will be able to "adjust" rates of return and depreciation *after* incumbents face facilities-based competition is nonsense. Rather, in an environment where emerging competition threatens to strand investment, prices will decline over time and firms will seek to *frontload* their recovery of costs (through rapid depreciation and higher returns on capital). It is frivolous to suggest that a regulator will be able to wait until competition has developed and *then* raise rates of return and depreciation to compensate for the very risks that have already changed market conditions.

3. The FCC and its supporters also claim that TELRIC is somehow more palatable because other regulators have adopted similar methodologies. Even if that were true, the defense would be a weak one: others' errors do not justify one's own. In any event, the premise of the FCC's argument fails.

First, the FCC and its supporters say that, while the FCC's rules were stayed on appeal, state commissions "independently and voluntarily" adopted the FCC's approach. FCC Br. 25; *see also* WorldCom Br. 18-19; Sprint Br. 7 n.3; AT&T Br.

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[25] And the threat is precisely one of *constant* downward repricing. Contrary to the suggestions of some petitioners, *see, e.g.*, WorldCom Br. 39, the mechanism for applying TELRIC to a particular incumbent through the arbitration of an interconnection agreement does not necessarily mean that TELRIC prices will be re-calculated once every few years and remain fixed in the interim. Each time a different new entrant requests an arbitration, it can trigger a new calculation of TELRIC prices based on the most recent technology. And, under the FCC's interpretation of 47 U.S.C. § 252(i), other entrants can then immediately adopt the new prices.

19-21, 33. But they are wrong to contend that state commissions, to the extent they embraced TELRIC, did so "independently and voluntarily." State commissions understandably had little incentive to experiment with other approaches while the Eighth Circuit's jurisdictional ruling was still being reviewed in this Court. And the FCC is altogether wrong in saying that "[t]he federal courts have consistently endorsed [TELRIC] on the merits in their review of the state commissions' actions." FCC Br. 26. Even before the Eighth Circuit's decision, numerous district courts had concluded that a blank-slate approach is impermissible.[26]

Second, the FCC claims that the Interstate Commerce Commission "employed a forward-looking cost methodology based on 'most efficient' alternatives to determine the maximum rate that a market-dominant railroad could charge a coal shipper that was the 'captive' of that railroad." FCC Br. 24; *see also* AT&T Br. 32. But the ICC's "stand-alone cost" methodology was different from TELRIC in critical respects. Whereas TELRIC assumes that an entire network is rebuilt from scratch, the ICC's stand-alone cost methodology assumed a railroad built to serve the needs of just one shipper (or group of shippers) on a particular route, thereby extinguishing any economies that might exist between that route and the rest of

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[26] *MCI Telecomms. Corp. v. GTE Northwest, Inc.*, 41 F. Supp. 2d 1157, 1168-69 & n.7 (D. Or. 1999); *MCI Telecomms. Corp. v. BellSouth Telecomms., Inc.*, 40 F. Supp. 2d 416, 421-22 (E.D. Ky. 1999); *U S West Communications, Inc. v. Thoms*, Civil No. 4-97-CV-70082, slip op. at 66-70 (S.D. Iowa Jan. 25, 1999), *remanded in part on other grounds*, slip op. at 4 (S.D. Iowa Apr. 19, 1999), *appeal pending*, No. 99-2589 (8th Cir.); *Southwestern Bell Tel. Co. v. AT&T Communications of Southwest, Inc.*, No. A 97-CA-132, 1998 WL 657717, at *11 (W.D. Tex. Aug. 31, 1998), *appeal pending*, No. 98-51005 (5th Cir.); *AT&T Communications of South Central States, Inc. v. BellSouth Telecomms., Inc.*, 20 F. Supp. 2d 1097, 1101-02 (E.D. Ky. 1998); *MCI Telecomms. Corp. v. Pacific Bell*, No. C 97-0670, slip op. at 12-13 (N.D. Cal. Sept. 29, 1998), *appeal pending*, No. 00-16135 (9th Cir.).

the network.[27] For that reason, "stand-alone cost" was usually *higher* than the incumbent's actual forward-looking cost. *See* Kahn, *How Not to Deregulate* 61-62 n.40. That is why the "stand-alone cost" of constructing a new road was given weight as only one of four factors in determining rates.[28]

Finally, the FCC claims that "[t]he European Commission has endorsed a cost methodology similar to TELRIC." FCC Br. 25; *see also* AT&T Br. 21, 33. In fact, the EC has embraced a forward-looking approach only as a future goal.[29] More important, insofar as here relevant, the methodology endorsed in principle is not "similar to TELRIC": there is no indication that the EC intends to employ the kind of extreme blank-slate version under which carriers are assumed to rebuild their entire network from scratch at utility rates of depreciation and return.[30] For example, one implementing regulator (Oftel, the FCC's British counterpart) has ruled that, absent a specific showing of inefficiency, the incumbent's actual current expenditures on capacity additions should be used to determine rates.[31]

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[27] *See, e.g., FMC Wyoming Corp. and FMC Corp. v. Union Pac. R.R., et al.*, STB Docket No. 42022, STB Ex Parte No. 346 (Sub-No. 29A), 2000 STB LEXIS 269, at *37 (May 10, 2000); *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 189 (D.C. Cir. 1984); AT&T Br. 32 n.25.

[28] *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 534 (1985); *Consolidated Rail Corp. v. United States*, 812 F.2d 1444, 1450-51 (3d Cir. 1987); *see also* Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, § 205, 90 Stat. 31, 41.

[29] *See* Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market*, C(97) 3148, § 3.5 (Oct. 1997). For now, the EC has instructed regulators to use a "best current practice" approach. *Id.*

[30] *See id.* §§ 3.3, 3.5.

[31] *See* Oftel, *Access to Bandwidth: Indicative Prices and Pricing Principles* ¶ 9 (May 2000).

C. The Act Must Be Construed To Provide for Recovery of the Actual Costs Incurred in Providing a Government-Compelled Service.

1. Compelling incumbents to turn over exclusive use of network facilities to competitors (*see* 47 C.F.R. § 51.309(c)) constitutes a taking of private property. This is true whether the "forced lease" of network elements is viewed as a physical occupation, *see Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 426 (1982), a government-mandated easement over a discrete portion of the network, *see Nollan v. California Coastal Comm'n*, 483 U.S. 825, 831-37 (1987), or a government requisition of a certain quantum of the network's output, *see Liggett & Myers Tobacco Co. v. United States*, 274 U.S. 215 (1927).

Serious constitutional difficulties are presented by a regime that drafts a particular provider into government service and then refuses to pay for the actual outlays necessitated by that government mandate. The statute cannot be construed to authorize a methodology that implicates these constitutional problems. *See, e.g., United States v. Security Indus. Bank*, 459 U.S. 70, 78 (1982); *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring); *Solid Waste Agency of Northern Cook County v. United States Army Corps of Engineers*, 121 S. Ct. 675, 683 (2001).

2. The overarching constitutional fact in this case is government compulsion: the government is forcing incumbents continually to produce goods below the cost necessary to produce them. It is one thing for the government to set a price and allow firms to make the voluntary choice whether to do business on those terms. It is quite another when, as here, the government forces the firm to produce at a cost that is noncompensatory. *Compare Bowles v. Willingham*, 321 U.S. 503, 517 (1944) (no taking because no requirement that property be rented), *with United States v. New River Collieries Co.*, 262 U.S. 341, 343-44 (1923) (forced production of coal

for government use constitutes a taking of property). This Court has recognized on many occasions that voluntary price controls are distinguishable from compelled production at prices fixed by the government. *See, e.g., FCC v. Florida Power Corp.*, 480 U.S. 245, 251-52 (1987); *Loretto*, 458 U.S. at 440 ("In none of these [price control] cases . . . did the government authorize the permanent occupation of the landlord's property by a third party.").

The fundamental purpose of the Just Compensation Clause it to put the private parties "in as good position pecuniarily as if the use of their property had not been taken." *Phelps v. United States*, 274 U.S. 341, 344 (1927). Where the government is compelling continued production of goods, "[i]t is the owner's loss, not the taker's gain, which is the measure of the value of the property taken." *United States v. Causby*, 328 U.S. 256, 261 (1946). The government must cover the owner's cost of production in full to pay "the owner's loss" and to place the firm "in as good a position pecuniarily as if the use of [its] property had not been taken."

"When a private business is possessed and operated for public use, no reason appears to justify imposition of losses sustained on the person from whom the property was seized." *United States v. Pewee Coal Co.*, 341 U.S. 114, 117-18 (1951) (plurality opinion). *See also United States v. General Motors Corp.*, 323 U.S. 373, 385 (1945) (Douglas, J., concurring in part) ("It would indeed be a novel rule of law which allowed the Government to oust a person from a portion of his leasehold, occupy the premises, but pay only a part of the rent, leaving the balance to be paid by him who though ousted holds the balance of the term."). This is but a specific application of the rule that the government cannot force a party to operate indefinitely at a loss. *See, e.g., Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920); *Pacific Tel. & Tel. Co. v. Tax Comm'n*, 297 U.S. 403, 413 (1936); *Northern Pac. Ry. v. Department of Pub. Works*, 268

U.S. 39, 43-45 (1925); *Railroad Comm'n v. Eastern Texas Ry.*, 264 U.S. 79, 85-86 (1924); *Missouri Pac. Ry. v. Nebraska*, 217 U.S. 196, 205, 208 (1910).

In this context, it does not aid the government to assert that TELRIC merely mimics a "market value" that would exist in a hypothetical competitive market. This is so for two reasons: (1) there is no real market; it is entirely the government's imaginary construct, and (2) even if there were available market alternatives, the government cannot dragoon a particular firm into operating below that firm's costs.

This Court has long made clear that market value may not be used as the basis for compensation in the absence of an objective standard of comparable and reliable market transactions. *United States v. Virginia Elec. & Power Co.*, 365 U.S. 624, 633 (1961); *United States v. John J. Felin & Co.*, 334 U.S. 624, 630 (1948) (plurality opinion). As the Court has said, in the absence of such transactions, market value is merely a "guess." *United States v. Miller*, 317 U.S. 369, 374-75 (1943); *United States v. 564.54 Acres of Land*, 441 U.S. 506, 513 (1979) (listing "public facilities such as roads or sewers" as within that category of property "so infrequently traded" as to render the concept of market value meaningless).

Accordingly, there are real limits on the ability of the government, in the name of "mimicking" the effects of competition, to avoid paying a producer's costs based on an imaginary construct. The government is not attempting to avoid paying "unreasonable profits" over and above the producer's costs; rather, it is seeking to avoid the costs that it is actually imposing.

Under well-established precedents, any methodology that compels a producer to achieve a level of cost efficiency (1) must be based on a determination that the producer can realistically achieve that level of efficiency, and (2) must be tethered to an objective benchmark of cost or value outside the

government's control. Thus, by denying recovery for "imprudent investment," the government has concluded that the producer can realistically achieve a lower cost, on the theory that a producer can avoid being imprudent. Incentive pricing, such as price-cap regulation, takes the individual provider's actual cost of service as a benchmark and then imputes achievable levels of future efficiency based on real market data. Price ceilings are also constitutionally permissible, at least where such ceilings are based on average costs calculated from actually observed industry data, *see In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769 (1968), and where producers are free to decline to produce, *see FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979) (citing *Permian Basin*, 390 U.S. at 769, 770-71).

Nor can the government suggest that it has found a "comparable market" by imagining that the producer is situated differently than it is in reality. In *General Motors*, the United States condemned a one-year interest in a commercial warehouse filled with GM's equipment. The Court rejected the government's argument that it should pay only a prorated share of the long-term lease price of an empty warehouse: the government was not free to assume that GM had a more attractive asset than it actually had. "If such a result be sustained we can see no limit to utilization of such a device; and, if there is none, the Amendment's guaranty becomes, not one of just compensation for what is taken, but an instrument of confiscation fictionalizing 'just compensation.'" 323 U.S. at 381. Although the Court endorsed the use of market value, it directed that value be determined by considering the "extraordinary and unusual" circumstances at issue. *Id.* at 383. Accordingly, the Court held that the costs of moving GM's equipment out of the warehouse and "preparing the space for occupancy" by the government, as well as any damage caused by the temporary occupancy, must be included in the calculation of just compensation. *Id.* at 383-84. In other words, the government was required to take the warehouse *as it existed*,

and the unavoidable costs of producing the output demanded by the sovereign (an empty warehouse) could not be ignored.

The Fifth Amendment would be eviscerated if the government could deny paying costs based on entirely conjectural efficiencies, limited by nothing other than its own imagination. Indeed, the very basis for using fair market value as a measure of compensation is to provide an objective check against the government; it turns the constitutional guarantee on its head to permit the government to base compensation on a "market value" that it invents.

Nor is this case in any respect like the "fair value" or "replacement cost" regulatory regimes of the early twentieth century. *See, e.g., Smyth v. Ames,* 169 U.S. 466 (1898). In those cases, investors voluntarily dedicated their property to the regulatory regime and were paid in advance, through an appropriately adjusted rate of return, for the risk that they would not recover all their costs. In this case, by contrast, incumbents undertook retail service obligations under a regime that promised full-cost recovery at a utility rate of return. The 1996 Act terminated that regulatory regime, *see* 47 U.S.C. § 253(a), and then *compelled* incumbents to provide their networks for a new purpose outside the scope of the original dedication and subject to an entirely different cost-recovery regime — the production of wholesale telecommunications services for other retailers.

At bottom, TELRIC represents the audacious claim that the government can dictate market value where no market exists. At the same time, it can eliminate any reference to the only real-world measure of value — the actual costs of production. By this reasoning, General Motors could be forced to use its consumer truck factories to build M-1 tanks, with compensation determined by a Defense Department extrapolation of the costs that might be incurred by the "least cost, most efficient" tank factory. If the government is free to ignore all external measures of cost, in favor of its own subjective

valuation, it becomes a judge in its own cause. Without reference to objective indicators of value, judicial review of a price fixed by the government is impossible. *See Monongahela Navigation Co. v. United States*, 148 U.S. 312, 327-30 (1893). *See also Duquesne Light Co. v. Barasch*, 488 U.S. 299, 317 (1989) (Scalia, J., concurring) ("capital reasonably expended to meet the utility's legal obligation to assure adequate service . . . may need to be taken into account"). Congress clearly did not intend to test these principles of just compensation (or judicial control thereof) in Section 252(d)(1), and the statute therefore cannot be interpreted to authorize the FCC to do so.

II. PETITIONERS' DEFENSE OF THE FCC'S ADDITIONAL-COMBINATIONS RULES IS PROCEDURALLY BARRED AND SUBSTANTIVELY MERITLESS.

Under the FCC's "additional-combinations" rules, 47 C.F.R. § 51.315(c)-(f), an incumbent carrier must combine previously unconnected pieces of its network and must combine pieces of its network with a competitor's network — all solely for the benefit of its competitors. The FCC's rules thus allow a competitor to conscript the incumbent's personnel to perform the work necessary to alter the existing network to suit the competitor's demands, whether or not the requesting carrier is capable of combining the elements on its own. *Id.* § 51.315(c)-(d). Petitioners' attempts to defend these rules are both procedurally improper and substantively incorrect.

A. Petitioners Abandoned Their Claim When They Failed To Raise It the Last Time They Sought Review in this Court.

In its 1997 decision in this case, the Eighth Circuit invalidated Rules 315(c)-(f) on the ground that the FCC lacked statutory authority to require incumbents to combine network elements for their competitors. *See Iowa Utils. Bd.*, 120 F.3d at 813, 819 n.39. Although the FCC, WorldCom,

AT&T, and others all filed petitions seeking review of *other* determinations — including the Eighth Circuit's invalidation of Rule 315(b), which prohibited incumbents from separating already-combined network elements — none of them sought review of the invalidation of the additional-combinations rules. Instead, they made a strategic decision to focus on other issues. By failing to include that challenge, the FCC and its supporters waived it.[32]

In that respect, this case is controlled by *Communist Party of the United States v. Subversive Activities Control Board*, 367 U.S. 1 (1961). After initially prevailing in this Court on other grounds, the petitioner pressed on remand a document-production issue that it had not raised in its original petition for certiorari. *See id.* at 30. Following another adverse decision, the petitioner sought certiorari again, presenting the document-production issue for the first time in this Court. *See id.* Although this Court granted the petition, it refused to address the document-production issue because the "error could have been raised here five years ago." *Id.* "We hold that the Communist Party abandoned its claim of error . . . by failing to raise that question in its previous petition for certiorari here." *Id.* at 31-32.[33]

Contrary to the FCC's argument (FCC Br. 37 n.16), it is no answer to the *Communist Party* holding that the Eighth Circuit, on remand, reiterated its prior conclusion on the additional-combinations issue. *See* Pet. App. 29a.

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[32] Although AT&T has claimed (AT&T Cert. Reply 8 & n.4) that it raised this issue in its prior petition for certiorari, the relevant rules were neither mentioned nor cited anywhere in that petition. *See* Petition for Certiorari at 9-10, 13, *AT&T Corp. v. Iowa Utils. Bd.*, No. 97-826 (U.S. filed Nov. 27, 1997).

[33] The rule is no different in the federal courts of appeals, which routinely decline to hear issues that could have been raised in a prior appeal. *See* Brief in Opposition of BellSouth, SBC, and Verizon, Nos. 00-555, *et al.*, at 15 n.9 (U.S. filed Nov. 17, 2000) (collecting cases).

Communist Party establishes that petitioners may not "resurrect [a] claim" by raising the same issue on "remand," *whether or not* the decision-maker below affords them the courtesy of reiterating its prior views in a new opinion. 367 U.S. at 32.

Nor is petitioners' position strengthened by their claim that this Court's prior decision, by upholding the validity of Rule 315(b), breathed new life into their abandoned challenge by somehow undermining the Eighth Circuit's grounds for invalidating Rules 315(c)-(f). This kind of incrementalism cannot be permitted. If it were, petitioners would endlessly convert each succeeding decision of this Court into a fresh opportunity to relitigate questions that they chose not to bring before this Court, and then to seek yet further review of those questions in subsequent petitions for certiorari.[34] The Court rejected just such a "'sporting theory' of justice" in *Communist Party*. *Id.* at 31.

B. The Additional-Combinations Rules Are Incompatible with the Statute.

Even if petitioners had properly preserved this issue, their claims are wrong. The Act nowhere imposes on incumbents an obligation to deploy their personnel to reconfigure facilities for the benefit of a competitor — even where there is no dispute that the competitor could undertake this work itself. In fact, the statute provides just the opposite. Section 251(c)(3) requires incumbents to provide access to network

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[34] For example, the court of appeals' ruling on the additional-combinations rules is related to its separate ruling — challenged neither in the current case nor in 1997 — invalidating the FCC's "superior-quality" rules (47 C.F.R. §§ 51.305(a)(4), 51.311(c)), under which incumbents must provide a higher quality of access to their network elements than they provide to themselves. *See* Pet. App. 25a-26a. If petitioners were to prevail here on the additional-combinations rules, they might claim next that this Court's decision entitles them to reopen the court of appeals' decision on the superior-quality rules.

elements "in a manner that allows *requesting carriers to combine such elements* in order to provide . . . telecommunications service." 47 U.S.C. § 251(c)(3) (emphasis added). Congress thus envisioned that competitors, not incumbents, would be responsible for combining elements for their own use.

The FCC asserts that a different clause in Section 251(c)(3) — requiring "nondiscriminatory access to network elements" — authorizes it to impose the additional-combinations rules. *See, e.g.*, FCC Br. 33-34, 37-38. It notes that this Court held in *Iowa Utilities Board* that Section 251(c)(3) was ambiguous and that it was reasonable to read the nondiscrimination obligation to prohibit such action. *See* 525 U.S. at 394-95. This is decisive, in its view, because "[r]equiring ILECs to combine previously uncombined UNEs upon request is the 'flip-side' of prohibiting them from separating already combined UNEs." Sprint Br. 24; FCC Br. 40.

The issue here, however, is very different from the one in *Iowa Utilities Board*. There, the conduct in question involved taking affirmative steps to *disassemble* the network, "'not for any productive reason, but just to impose wasteful reconnection costs on new entrants.'" 525 U.S. at 395 (quoting Reply Brief for Federal Petitioners at 23, Nos. 97-826, *et al.* (U.S. filed June 17, 1998)). A rule that prevented "sabotage" of network elements, the Court concluded, could reasonably be understood to "find[] its basis in § 251(c)(3)'s nondiscrimination requirement." *Id.* at 394-95.

That analysis does not remotely suggest that the FCC has authority to adopt the different rules at issue here. It is one thing for the FCC to prohibit incumbents from "sabotaging" their networks when they turn facilities over to entrants; it is quite another thing to force incumbents, on the mere "request" of a competing carrier, to reconfigure their networks for the competitor's benefit, even when the competitor could reasonably combine the elements itself. An incumbent

cannot reasonably be said to "discriminate" against a competitor when it declines to put its own labor force and ingenuity at the competitor's disposal. Rather, when either an incumbent or an entrant wants to assemble a new combination of elements, it must deploy its workforce and invest its resources to accomplish that task.[35] This leaves the incumbent and the entrant on an equal footing: both take the network as they find it. Nothing in *Iowa Utilities Board* supports the conclusion either that the statute is ambiguous as to the different issue presented here or that the FCC's rule is reasonable.

Indeed, petitioners themselves have previously stated unequivocally that the additional-combinations rules do not present the same question that the Court addressed in *Iowa Utilities Board*. The government told the Eighth Circuit in 1997 that it saw "no conflict" between invalidating Rules 315(c)-(f) and upholding the prohibition in Rule 315(b) against an incumbent's "ripping apart network elements that already are combined in its 'existing network' for the sole purpose of increasing its competitors' costs." Response of Federal Respondents to Petitions for Rehearing at 9 (8th Cir. filed Oct. 1, 1997) ("FCC Rehearing Response").[36]

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[35] Thus, contrary to WorldCom's assertion (Br. 48), both a competitor and an incumbent may serve a customer seeking a second line by doing the work necessary to combine the relevant elements. Nor is there any basis for WorldCom's suggestion (Br. 47-48) that incumbents bar access to their facilities to combine elements. In fact, incumbents must (and do) comply with extensive FCC rules regarding access to their network. *See, e.g.*, 47 C.F.R. §§ 51.321, 51.323. Competitors have ample recourse if an incumbent fails to adhere to those duties.

[36] AT&T and WorldCom likewise stressed the difference between additional-combinations requirements and provisions such as "[Rule 315(b)] that require equal access to the [incumbent's] existing network." Opposition of Intervenors in Support of FCC to Petitions for Rehearing at 10 (8th Cir. filed Oct. 1, 1997) ("AT&T/WorldCom Rehearing Opp."). Unlike the rules now before the Court, they said, Rule 315(b) "validly implement[s] other provisions of the Act (the ban on nondiscrimination), and it requires *no additional work* by the [incumbent]." *Id.*

Nor did the FCC even cite Section 251(c)(3)'s nondiscrimination ban in the relevant portion of its *Order* (¶¶ 289-297). Instead, the scope of that requirement is discussed elsewhere in the order. *See id.* ¶¶ 298-316.[37] Rather, the FCC rested its additional-combinations analysis on the same mistaken premise that both this Court and the Eighth Circuit have rejected. The FCC required blanket access to network elements on the theory that Section 251(c)(3) "'impose[s] on an incumbent LEC the duty to provide all network elements for which it is technically feasible to provide access'" — a theory that this Court said was "undoubtedly wrong." *Iowa Utils. Bd.*, 525 U.S. at 391 (quoting *Order* ¶ 278).

Operating on the same discredited theory, the FCC believed that it could lawfully require incumbents to "perform the functions necessary to combine elements, even if they are not ordinarily combined in that manner, provided that such combination is *technically feasible*" (and, relatedly, that it will not interfere with other competitors' access to network elements). *Order* ¶ 296 (emphasis added). The FCC was explicit in acknowledging that its technical-feasibility standard for additional combinations "is consistent with the method we have adopted to identify unbundled network elements." *Id.* ¶ 295. But the FCC's approach is *not* consistent with the vision Congress enacted. On the contrary, the statute plainly contemplated that requesting carriers would take the incumbent's network as they find it, and that, when necessary, *they* would "combine [network] elements in order to provide . . . telecommunications service." 47 U.S.C. § 251(c)(3).

The lack of fit between the FCC's additional-combinations rules and the structure of the 1996 Act is further demonstrated by the inconsistency between those rules and the established principle that the FCC may not mandate "superior-quality

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[37] That failure provides reason enough to reject this argument. *See SEC v. Chenery Corp.*, 332 U.S. 194 (1947).

access" to an incumbent's facilities. The FCC promulgated rules under which, at the request of a competitor, incumbents must provide network elements (and access to those elements) of a quality superior to what the incumbent provides itself. *See* 47 C.F.R. § 51.311(c); *Order* ¶ 314 & n.680. On review, however, the Eighth Circuit twice held that the FCC lacks authority to mandate such superior-quality access. *See Iowa Utils. Bd.*, 120 F.3d at 812-13 ("[S]ubsection 251(c)(3) implicitly requires unbundled access only to an incumbent's *existing* network — not to a yet unbuilt superior one."); Pet. App. 25a-26a (reaffirming that result). Neither the FCC nor any private party has ever sought review of those determinations.

The additional-combinations rules are simply a species of superior-quality regulation. Indeed, the FCC and other petitioners have previously conceded that, because additional-combinations rules allow competing carriers to demand network elements in a superior, pre-combined form, those rules raise the same legal issues as the superior-quality rules.[38] Because it is now settled that the 1996 Act does not permit superior-quality access, the only conclusion consistent with the structure of the statute is that it does not permit additional-combinations requirements either. *See FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) ("A court must . . . interpret the statute as a symmetrical and coherent regulatory scheme, and fit, if possible, all parts into an harmonious whole.") (internal citation omitted).

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[38] *See* AT&T/WorldCom Rehearing Opp. at 10 (describing the Eighth Circuit as holding that incumbents could not be forced to act as "laborers" by "creat[ing] . . . new combinations or otherwise . . . afford[ing] superior access than that the LEC provides itself") (internal quotation marks and citation omitted); FCC Rehearing Response at 9 (the Court's ruling on the additional-combinations rules "was simply a restatement of its conclusion in striking down the related rule requiring [incumbents] to provide 'superior' network elements").

Nor does the final sentence of Section 251(c)(3) — which requires an incumbent to provide elements "in a manner that allows requesting carriers to combine such elements" — support the FCC's argument. Although, as this Court held in *Iowa Utilities Board*, the Commission could reasonably conclude that this sentence does not unambiguously "forbid[]" incumbents from providing in combined form elements that are *already* combined in the existing network, the Commission cannot read that sentence as *authorizing* the FCC to *require* incumbents to combine elements that are *not* already combined. On the contrary, as noted above and as the Eighth Circuit properly understood, the plain assumption of the sentence is that competing carriers themselves are responsible for combining elements in those circumstances. Though the incumbents are not *forbidden* from providing elements in pre-combined form if they choose to do so, the plain terms of Section 251(c)(3) provide no basis for a rule *requiring* incumbents to do so. *See GTE Serv. Corp. v. FCC*, 205 F.3d 416, 423 (D.C. Cir. 2000) (the FCC may not "impos[e] an obligation on LECs that has no apparent basis in the statute").[39]

Because they have no anchor in the statute's text or structure, Rules 315(c)-(f) cannot be saved by petitioners' naked appeal to spurious policy arguments. In particular, the FCC and its supporters claim that it would cost a competitor more to combine the elements itself than it would to conscript the incumbent's labor force to do the same work at an FCC-regulated price. FCC Br. 34; *see also* Sprint Br. 26. But just as the FCC could not impose a limitless unbundling

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[39] Nor is it relevant that incumbents receive "compensation" for the work they perform in combining elements. FCC Br. 41; AT&T Br. 44; Sprint Br. 26. The 1996 Act does not make incumbents' employees available for hire at the pleasure of their competitors. Rather, an incumbent's obligation to share its property, its work force, and its resources with its rivals is carefully limited in the Act. Compensation is a necessary prerequisite to this regime — to avoid a takings challenge — but it is hardly sufficient.

requirement on the theory that new entrants must be protected from "*any* increase in cost," *Iowa Utils. Bd.*, 525 U.S. at 389-90, neither can it support its additional-combinations rules on the theory that incumbent carriers may be able to combine elements at a lower cost.[40] Incumbent carriers can no doubt execute many tasks more efficiently than their competitors can. But a more efficient carrier's refusal to perform work for its less efficient competitor cannot sensibly be called "discrimination." *Compare* FCC Br. 34. Instead, it is known as competition — precisely what the 1996 Act is intended to stimulate.

CONCLUSION

The judgment of the court of appeals should be affirmed insofar as that court set aside FCC Rules 315(c)-(f) and 505(b)(1).

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[40] As the D.C. Circuit correctly noted in rejecting an unduly broad collocation requirement, "[i]t was precisely this kind of rationale, based on presumed cost savings, that the Supreme Court flatly rejected in *Iowa Utilities Board*." *GTE*, 205 F.3d at 424.

Respectfully submitted,

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
STEVEN G. BRADBURY
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 15th Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 North Courthouse Road
8th Floor
Arlington, Virginia 22201
(703) 974-2944

ANDREW G. MCBRIDE
SCOTT DELACOURT
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7135

HENRY WEISSMANN
MUNGER, TOLLES &
OLSON LLP
355 South Grand Avenue
Los Angeles, Calif. 90071
(213) 683-9100

Counsel for Verizon Entities

MARK L. EVANS
Counsel of Record
MICHAEL K. KELLOGG
SEAN A. LEV
KELLOGG, HUBER, HANSEN,
TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corp., SBC Communications Inc., and United States Telecom Association

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
CHRISTOPHER M. HEIMANN
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for SBC Communications Inc.

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309
(404) 249-4839

Counsel for BellSouth Corporation

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States Telecom Association

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